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STATEMENT OF

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(INSTALLATIONS AND ENVIRONMENT)

BEFORE THE SUBCOMMITTEE ON MILITARY QUALITY OF LIFE AND VETERANS AFFAIRS OF THE HOUSE APPROPRIATIONS COMMITTEE

INTRODUCTION

Mr. Chairman and distinguished members of this Subcommittee, I appreciate the opportunity to appear before you to discuss the housing and utility privatization initiatives of the Department of Defense (DoD).

Improving the Quality of life of military personnel and their families is a priority for the Department. Housing privatization is a key enabler that is providing more housing options for our military personnel. I want to express the Department appreciation for the Congress eliminating the limits on budget authority on the housing privatization program and for making the program permanent by also eliminating the previous 2012 sunset clause.

It is the policy of the Department that privatization allow installation commanders to focus on core defense missions and functions by relieving them of activities that can be done more efficiently and effectively by others. Utilities privatization is the preferred method for improving utility systems and services by allowing military installations to benefit from private sector financing and efficiencies. In both cases, we are leveraging better business practices and private capital and expertise to improve the management of military installations.

TAKING CARE OF OUR MILITARY FORCES

The President's FY 2006 Budget requests \$4.242 billion in new budget authority to construct, operate, and maintain military family housing. The budget request is an increase of over \$92 million from the FY 2005 request. This funding will allow the Department to eliminate all inadequate housing on United States (U.S.) bases by FY 2007, and overseas by FY 2009. This schedule, an improvement over last year's plan, accelerates the elimination of inadequate housing units at the Air Force's northern tier bases by one year leaving approximately 12,000 inadequate Air Force and Army overseas housing units to be addressed.

The Department's family housing construction budget request of \$2.1 billion, an increase from the \$1.6 billion FY 2005 President's budget request, supports traditional approaches to military housing construction as well as privatization.

At the outset of this Administration, the President identified military housing, including housing privatization, as a key component of his Presidential Management Agenda (PMA). From a total of 5,894 units of housing privatized at the end of 2000, DoD has accelerated to 87,512 units privatized today, and plans to privatize a cumulative total of over 185,000 units by the end of 2007. As you may recall, the Administration has tracked the Department's progress by the Presidential Management Agenda "Scorecard" Administered by the Office of Management and Budget. The Scorecard evaluated DoD in four areas: 1) elimination of inadequate housing units; 2) privatization of housing inventory; 3) average housing costs covered for Service members living in non-governmental housing; and 4) satisfaction of Service members who choose to live in revitalized private housing .

In FY 2005, DoD's housing privatization efforts received a **green** score for showing substantial progress in achieving these goals and/or progress in all these areas. Privatization of housing was the only individual federal initiative to receive the highest scorecard rating. Additionally, housing privatization is an important objective of the goal of the Acting USD(AT&L) to rationalize resources by making efficient use of the Department's housing resources. Through privatization we have leveraged DoD's resources with private sector capital to revitalize inadequate housing faster and a lower lifecycle cost to the taxpayer than traditional construction. We are pleased to be a part of these initiatives to eliminate inadequate family housing and increase the quality of life for our Service members and their families.

DOD's APPROACH TO IMPROVING HOUSING

In January 2001, the Department had approximately 180,000 inadequate family housing units (out of a total of 300,000 housing units worldwide). At the end of FY 2005, through housing privatization and the military construction program, we will reduce the number of inadequate units to about 67,079 (out of a total 136,017 housing units worldwide). By the end of FY 2006, we will have reduced the number of inadequate housing units to 36,572. This number will continue to come down as we pursue the objective of eliminating inadequate housing by 2007: As I previously testified, the Department's comprehensive strategy has three components:

1. Maintain Zero Average out-of-pocket costs through the Basic Allowance Housing (BAH)

In FY 2005, the Department achieved the objective of covering 100% average housing costs for our military families. The FY 2006 budget request continues our commitment. In 2000, the out-of-pocket cost for the average military member was 18.8 percent. Eliminating average out-of-pocket expenses is not only good for military families, but also serves to strengthen the financial profile of the housing privatization program by supporting a stronger potential income stream upon which the projects are based.

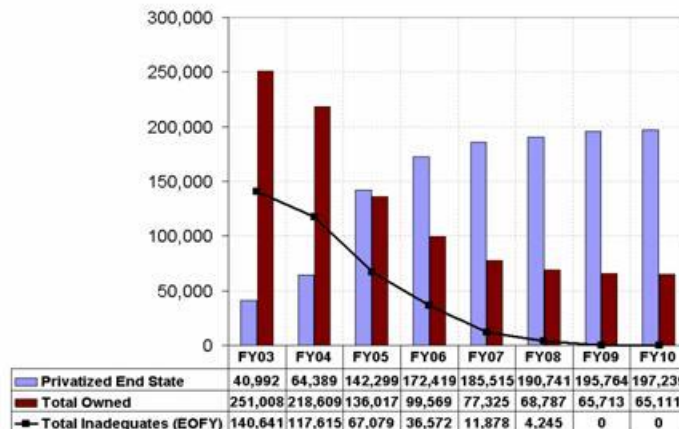
2. Eliminate Inadequate Units by 2007.

The FY 2006 budget request funds the continued elimination of inadequate family housing which we project by the end of FY 2006 to be only 36,572 units. The request also funds the complete elimination of inadequate units by end of year FY 2007 for U.S. based housing and FY 2009 overseas.

3. Emphasize/Increase Privatization.

The remarkable reduction in inadequate units is primarily due to acceleration of housing privatization efforts by the Services over the last four years. As I noted earlier, DoD plans to privatize 84 percent of its U.S. based housing inventory, or roughly 185,000 family housing units, by 2007. (See chart below)

Privatized End State vs. Inadequate Drawdown



Relying on the Community First

DoD relies on the private sector to provide quality housing options. Only when the private market demonstrates that it cannot supply sufficient levels of quality housing does the Department provide housing to our military families using privatization as its primary option followed by government-owned and leased housing. For example, we address our housing needs overseas through military construction and leasing in the absence of privatization authority. Currently, 73 percent of military families reside in private sector housing; including 11 percent in privatized military housing; and 27 percent in government-owned housing areas.

To ensure the Department makes the best investment decision, in determining the appropriate level of housing, a single and consistent methodology for calculating the requirement was introduced in January 2003. At U.S. bases, we identify the total number of military families seeking rental housing. We then allow for a pre-determined floor to meet specific on-base needs, such as key and essential members, military community desires, and historic housing requirements. A detailed market analysis then provides an estimate of suitable rental housing in the community which allows us to determine how many military families will be able to find housing in the local community. Any shortfall in community

housing is then added to the predetermined floor requirement to define how many housing units to provide and whether privatized or government-owned housing would best fill the need.

Adequately defining housing requirements, combined with increases in BAH, allows the Services to “thin out” family housing inventory by maximizing reliance on private sector housing. This limits government investment to where it is needed and also allows us to more efficiently manage government-owned housing where needed. The determination of housing requirements is an on-going, process. As decisions are made regarding the re-stationing of U.S. Forces from overseas and realignments resulting from the 2005 Base Closure and Realignment we will take those population shifts into account. As housing needs created by these realignments are identified, the flexibility provided by our privatization authorities will be immensely valuable in meeting those needs.

HOUSING PRIVATIZATION PROGRAM

DoD is increasing the number of, and accelerating the pace of, housing privatization projects. The Department has used privatization to advance this goal and obtain maximum benefit from its housing investment and rapidly improve the quality of life for our Service members. Installation commanders and Service members welcome privatization efforts to revitalize their family housing. For cost savings and efficient use of DoD’s housing assets, privatization is the preferred method to address DoD’s housing needs.

As of February 2005, the Department has awarded 43 projects. This includes over 87,000 military family housing units, which is a 58 percent increase since January 2004. DoD policy requires that privatization yield at least three times the amount of housing as traditional military construction for the same amount of appropriated dollars. The 43 awarded projects have permitted the Department, in partnership with the private sector, to provide housing for about \$767 million in military construction investment. The same level of construction activity would otherwise have required over \$11 billion if the traditional military construction approach was utilized. This reflects an average ratio of over 14 to 1, well exceeding program expectations.

The Department’s privatization plans in the FY 2006 budget will privatize 84 percent of its domestic family housing inventory, or roughly 185,000 units privatized by the end of FY 2007. By the end of FY 2006, we will have privatized 172,400 housing units.

Post-Award Monitoring

As privatization increases, we are no longer in the business of managing housing inventory, but rather are monitoring projects. The oversight provided by the ODUSD(I&E) emphasizes fiscal/physical oversight and monitoring of awarded projects via a framework known as the Program Evaluation Plan (PEP).

The PEP monitors how well housing privatization is providing quality housing for our families, as well as protecting other government interests such as repayment of loans. Because the primary relationship is between military tenants and private landlords, DoD works hard to limit its involvement to only essential protection of the Department’s interests. At every step responsibility to manage the housing is shifted to the private partner; including shifting the requirement to attract member tenants. By requiring Service members to pay their own utilities, responsibility for usage is placed with the resident. Day-to-day management is also handled between the tenant and the private sector landlord.

Since implementation of the PEP four years ago, the Department has continued to refine the process and ensure the quality of information collected is relevant and timely. Detailed, real time monitoring of projects is the responsibility of the Services and is implemented at each location in accordance with the management structure for that project. Programmatic data is collected semi-annually to allow headquarters oversight. Based on the PEP evaluations to date, we are confident that the program is meeting expectations and that projects are fiscally and financially sound. As we continue to gain greater experience and knowledge, the Department recognizes that the key to continued success will depend on allowing the private sector to bring forth best practices.

Major financial/project highlights from our recent PEP data include:

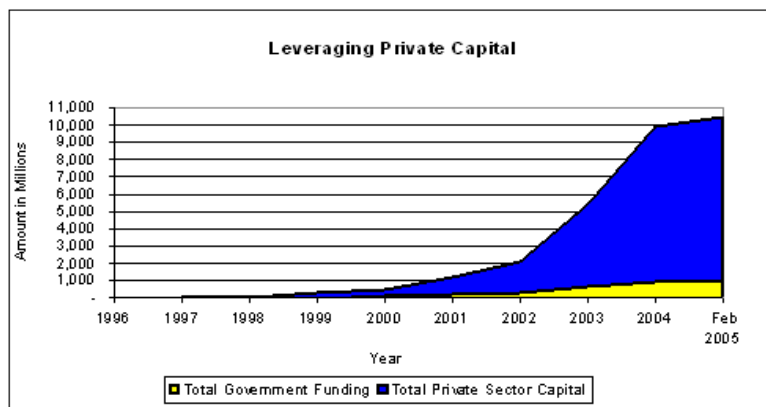
- All projects are financially sound.
- Of 43 projects awarded there has been one change in project ownership (Fort Carson, Colorado, 2004).
- For those installations which have a large number of personnel deployed for extended periods of time, the occupancies and Debt Coverage ratios of the privatized housing has remained high.
- To date we have had 20 national and/or local developers and 14 financing organizations successfully bid on MHPI projects.

- For installations where transferred, renovated, or newly constructed MHPI units are available to military family member tenants, the occupancy for the majority of our privatized units is in the range of 90-100 percent, although seven projects are in the 82-89% level, and one project is at 70 percent.

In addition, the PEP requires the Services to regularly report on customer satisfaction. Standard surveys are used by the Services to collect data. Of the 36 reporting installations included in our last PEP, responses and informal feedback from the privatized tenants has been positive. As might be expected, feedback improves as the renovation and replacement of houses progresses, but many tenants are initially impressed by improved response to trouble calls even prior to housing improvements being completed.

To date, we have completed renovation and construction on 10 projects (defined as the initial development phase, which is the period that eliminates inadequate units). We will continue to monitor occupancy rates and Debt Coverage Ratio to ensure the fiscal health of these projects. It is important to note that each project takes roughly 5-10 years to achieve the complete elimination of inadequate units (based on the Initial Development Plan) and that new construction and renovation will be taking place until FY 2014 or longer. The good news is that awarded projects show vastly improved operation and maintenance, better customer service, and greater Service member satisfaction, as measured in the customer surveys used to support the President's Management Agenda metric for tenant satisfaction. The awarded projects each have a plan and funding in place to achieve improved quality housing for our Service members and their families.

The 43 projects awarded to date reflect total development costs of \$10.3 billion with an investment by the Department of \$767 million (see chart below).



Implementation methodology used for this program encourages high quality construction and renovation of military family housing in an efficient manner. The methodology includes: 1) diligent scrutiny of selection of developers, 2) sound legal documents, 3) strong oversight and monitoring procedures, and 4) inclusion of protections for the government in terms and conditions of agreements.

PROGRAMMATIC ISSUES

Budget and Other Authorities

To effectively implement privatization, we need flexibility to make good use of appropriations. We are grateful for the support of Congress via permanent authorities and removal of the budget limitation. These two major actions allowed the program to move forward and to improve the already strong private sector participation in the competitive process.

However, for privatization, the Planning, Programming and Budgeting System (based on modeling) gives only a rough estimate of what the true project cost will be. Because public-private sector ventures, like the Military Housing Privatization Initiative (MHPI), are somewhat new it is important to understand how funding is used. Gap funding is provided via military family housing construction funds to address a project need. In most cases, the Services test the market through competitive solicitations which may cause funding gaps to increase or decrease based on what is negotiated. Project schedules, a change in requirements or interest rates, and other items also may lead to changing a project schedule or alteration of the timing of an award.

The Department has updated its budget exhibits with the FY 2006 submission to better explain planned use of funds in

execution of its privatization program. As mentioned above, these amounts can be expected to change as projects near completion. Thus, Congressional support to adjust funding for privatization projects may be required.

Barracks Privatization

In FY 2003, Congress authorized the Department of the Navy to undertake up to three pilot projects for the privatization of unaccompanied housing. Central to this pilot legislation is the authority to pay BAH to unaccompanied shipboard Sailors. Under Section 403, Chapter 7(f), of Title 37, United States Code (U.S.C.), these members are not entitled to receive full BAH. With the pilot unaccompanied housing privatization authority, a mechanism is put in place to provide the rental income stream needed by the private partner to finance investments in better housing.

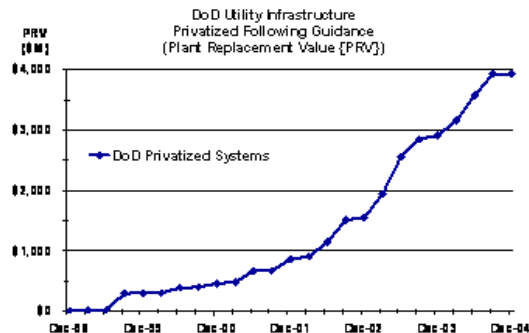
The execution of the Navy's first pilot project in San Diego is underway. A solicitation for this project was issued by the Navy in September 2004. The project involves the construction of 700 two-bedroom market-style apartments on Navy-owned land. These apartments will house 1,400 unaccompanied Sailors. In addition, the project includes the privatization of 516 existing unaccompanied housing spaces. Similar to our approach to family housing, we will use an investment approach with the Navy forming a public/private partnership (e.g., Limited Liability Company (LLC)) with a private sector entity. The Navy will invite up to four highly qualified interested parties from the private sector to submit detailed technical and financial proposals. Selection will be made by late spring 2005 and award in January, 2006, subsequent to notifying Congress.

The Navy intends to notify Congress of their intent to issue a solicitation for a second pilot project at Hampton Roads, Virginia, in the very near future. A study has been initiated to determine the feasibility of unaccompanied housing privatization in the Pacific Northwest. If feasible, this would become the Navy's third pilot project.

We appreciate the support from the Congress in our efforts to extend the principles of privatization to our critical bachelor housing needs. We envision that privatization will prove to be as successful in accelerating improvements in living conditions for our single Service members as it has been for family housing. The Department is also interested in working with Congress to determine whether privatization authorities can be used in other areas including lodging facilities and overseas facilities to address our housing needs.

UTILITY PRIVATIZATION

I would like to turn to another area of privatization which is achieving success—utilities privatization. Following years of under-funding, many military utility systems are not fully capable of supporting mission requirements or a quality workplace for Department personnel. Reliable utility services are essential to support our forces. Through the Utilities Privatization Program, the Department of Defense is taking advantage of industry innovations, economies of scale, efficiencies and private sector financing. Indeed, utilities privatization is the preferred method to obtain safe, environmentally sound and reliable utilities services.



For a number of years, the Department of the Army had been privatizing individual utility systems through various authorities. In the early 1990s the Department of the Air Force, reviewing the Army's efforts, began exploring options for privatizing DoD utility systems. The Department of the Navy also used privatization on a limited basis. In 1997, the Congress provided general authority to convey utility systems. Defense Reform Initiative Directive (DRID) #9 directed the Military Departments to develop a plan for privatizing all utility systems, except those needed for unique security reasons or where privatization is uneconomical. In December 1998, DRID #49 directed Defense Components to privatize every government-owned electric, water, wastewater, and natural gas utility system unless security concerns required federal ownership or privatization was uneconomical. However, utilities privatization proved to be more difficult than first

anticipated.

Building upon lessons learned and the utilities privatization plans submitted by the Military Departments, the Deputy Secretary of Defense issued revised guidance on October 9, 2002, which made numerous improvements in the evaluation process, including guidelines to ensure competition, requirements for completing a thorough economic analysis of benefits, and direction to retain sufficient contractual rights to ensure support of mission requirements. The guidance also encourages using other innovative methods to improve efficiencies and ensure reliable utility support in the event that a full title transfer is not economical.

The Military Departments and the Defense Logistics Agency are aggressively pursuing privatization evaluations. Ninety-four systems have been privatized following the guidance. This represents nearly \$4 billion of infrastructure. The Army has been particularly successful in using privatization to improve the safety and quality of utility services. The Services have made significant progress in adapting industry practices within the Department's procurement policies and the Federal Acquisition Regulations. Meanwhile, industry has worked closely with the Department to resolve barriers to our efforts. Many improvements and clarifications to the program have facilitated the use of common business practices in the utilities service contracts awarded in conjunction with the conveyance of a utility system.

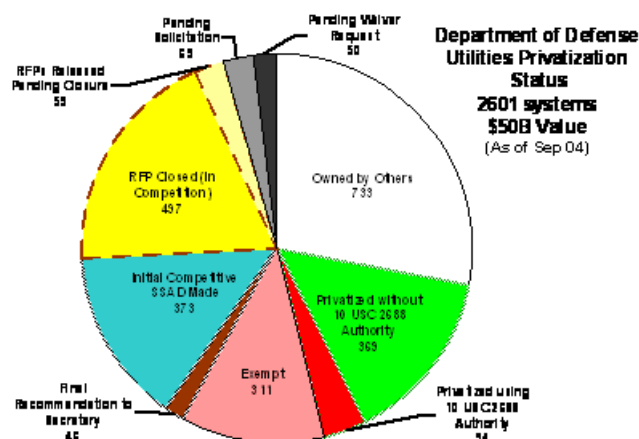
Several aspects of utilities privatization continue to complicate solicitations and negotiations. First, DoD utility systems normally serve only the DoD customer. Acquisition of one of these systems requires a substantial capital investment by the purchaser. Under standard industry and regulatory practice, the system would be provided by the customer at no cost. Depending on the type of utility, this transfer may be considered a contribution in aid of construction, which is gross income to the utility provider for tax purposes. Adapting the common business model to account for fair market value takes time to resolve.

Secondly, under the utilities privatization program, the purchaser is expected to recover capital and operating costs solely from the government under a utilities service contract following Federal Acquisition Regulations. This differs from housing privatization where capital costs are amortized over time by tenant rents.

Third, it is difficult to appraise the fair market value of military utility systems because, unlike housing, comparable sales are not readily available. Uncertainty as to value becomes a significant issue in negotiations associated with the establishment of the price of the resulting utility services contract.

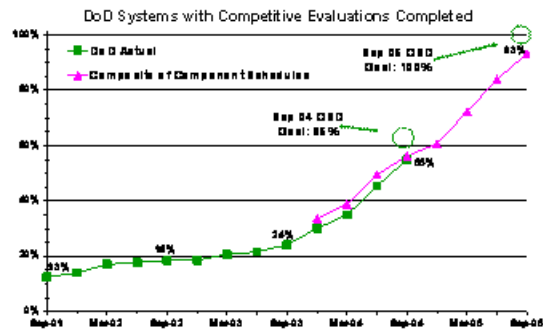
Fourth, establishing the long-term price structure and conducting long-term economic analyses can be problematic. Privatization contractors belong to both the regulated and unregulated sectors. Even in the regulated sector, it is often the case that the utilities service required after conveyance of a distribution system will not match the established tariff rates of a particular Public Utility Commission. Consequently, the price of the resulting utility service contracts must often be negotiated as a special business case for the utility provider. This further complicates procedures for making price adjustments to long-term contracts.

The resolution of these issues, as well as the sheer volume of solicitations, has challenged contracting officers and industry representatives to improve their approach and achieve more timely evaluations.



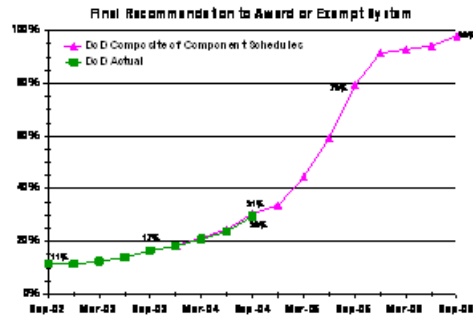
For a large majority of evaluations, the Army and Air Force have transitioned to a center of excellence approach by

utilizing the Defense Energy Support Center, a unit of the Defense Logistics Agency.



This centralized approach has improved timeliness and interaction with industry. Of the 2,601 utility systems used by the Department, 733 systems are already owned by other entities such as foreign governments. The Defense Components have privatized a total of 463 systems. Three hundred and eleven systems were exempted for economic or security reasons. Solicitations on 975 systems were under evaluation as of September 30, 2004, and less than 70 systems are still pending an initial solicitation to make a competitive evaluation.

The Department has either provided an exemption for security reasons or completed a competitive evaluation on 55 percent of the systems available for privatization. In spite of the challenges enumerated earlier, DoD is on track to complete competitive evaluations on over 90 percent of systems available to privatize by September 30, 2005. In many cases, competitive solicitations have not yielded definitive results to support a



decision to convey or exempt a utility system. This is primarily due to a lack of responses to the solicitation. In those cases, the Military Departments pursue discussions with local utility providers to further assess the potential for privatization. At least 95 percent of this second phase of evaluations should be complete by September 2006.

Utilities privatization represents a comprehensive effort to obtain safe, environmentally sound, and reliable utilities services. Although more complex than originally anticipated, program execution is proceeding in a methodic manner that encourages competition between various industry participants. The Military Departments have incorporated an independent review of the economic analysis at various levels of their utilities privatization teams including the Secretariat level. They are also ensuring that the long-term contracts and partnerships with industry consistently meet mission requirements in a cost effective manner.

CONCLUSION

The housing privatization program is crucial to a decent quality of life for our Service members. The Department has aggressively used privatization to advance the goal of eliminating inadequate housing and obtaining maximum benefit from housing investments. Similarly, utilities privatization has upgraded systems to industry standards in the most cost effective manner. DoD will continue its efforts to utilize these tools and oversee the long-term management of resulting contracts.

In closing Mr. Chairman, I again express the Department's appreciation for the strong support of the military housing and utilities privatization programs. I look forward to working with you Mr. Edwards, and all members as we continue to improve the quality of live of military personnel and the management of the Nation's Defense infrastructure.